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BEFORE THE ARIZONA CORPORATION COMMISSION

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JIM IRVIN
COMMISSIONER-CHAIRMAN
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COMMISSIONER

IN THE MATTER OF THE COMPETITION IN)
THE PROVISION OF ELECTRIC SERVICES)
THROUGHOUT THE STATE OF ARIZONA)

DOCKET NO. RE-00000C-94-0165

ATTORNEY GENERALS' MEMORANDUM
OF POINTS AND AUTHORITIES
RE: STRANDED COSTS

The Attorney General, a party to this proceeding, hereby submits the following Memorandum of Points and Authorities in support of his proposed method for calculating and allocating stranded costs, if any, occasioned by the Commission's December 31, 1996 rules opening electric power generation to competition. The Attorney General urges this Commission to adopt a market method of calculating stranded costs and an efficient pro-competitive method of allocating and paying these costs, if any.

Arizona Corporation Commission
DOCKETED

MAR 16 1998

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1 **MEMORANDUM OF POINTS AND AUTHORITIES**

2
3 **I.**

4 **THE COMMISSION MUST USE FREE-MARKET ANALYSIS IN FASHIONING ITS**
5 **STRANDED COSTS POLICY**

6 After an entire year of working groups that failed to reach consensus and a month-long
7 evidentiary hearing, the Commission now faces the considerable challenge of crafting an order
8 determining how stranded costs will be calculated, allocated and paid. The Commission's
9 stranded cost decision will have profound effects on the future of electric energy consumption in
10 this State. The Attorney General urges the Commission to adopt a single overriding principle not
11 only as to the various parties claims to equity, but also as to budding competition. That principle
12 is: "First, do no harm." (Scott, Opening Statement for RUCO, 2/9/97, tr. p. 52, l. 19-21)¹

13
14 **A. The Commission's Order Must Further the Goal of Competition by**
15 **January, 1999**

16 Undisputably, free market competition, as compared to any type of ongoing regulation, is
17 the best guarantee of high quality, low price, cost-effective, technologically advanced and efficient
18 generation and demand management of the commodity electric power. (Direct testimony of
19 Kenneth Gordon, 1/9/98, p. 3, l. 1-9; Davis, tr. p. 3863, l. 7-13.) Simply put, moving toward the
20 "genius of the marketplace" is in the public interest. (Testimony of Dr. Daniel Fessler, 2/10/98, p.
21 453, l. 20-25, p. 448, l. 19-20.)

22 By December, 1996, the dye was cast and the Commission established competition as the
23 electric power paradigm for the next millennium. Now, for the first time in over seven decades the
24

25 ¹ See also, remarks of Karen Carageen, president of the Small Business Survival
26 Committee. National Association of Attorneys' General Hearing on Electric Industry
27 Restructuring, Washington, D. C., November 13, 1997, p. 120, l. 20 - 21. "First, do no harm in
28 undertaking of restructuring this highly complex and regulated industry." Ms. Carageen is a
nationally-recognized spokesperson on tax issues, budget matters, regulation, and government
efficiency.

1 commission must consider and balance the potential for harm to the coming competitive Arizona
2 generation market against the potential injury to ratepayers, shareholders and affected utilities in
3 any order it issues. Under the new vision of Arizona's electric power future, the interest of
4 fostering competition is of equal weight to the other traditional interests. By adopting its
5 restructuring Rules, the Commission codified a new "compact" with the people and companies of
6 Arizona; the Commission has promised Arizona a competitive retail power market and it has
7 promised to get us there.

8 Of course, the Commission cannot "create" competition. Competition is already firmly
9 established in the wholesale power market, and will continue to flourish wherever it can, with or
10 without the Commission. The Commission's order on stranded costs can do nothing to create
11 competition, but can do much to prevent it. To strike the right balance, the Commission must now
12 get out of the way. By removing regulatory barriers, by avoiding market distortion through
13 stranded cost overcompensation, by ensuring competitive incentives and by limiting its protective
14 role to only those situations where protection cannot be had elsewhere, the Commission can honor
15 its new "competition compact" with the citizens of this State.

16 Because the value of competition is no longer subject to debate, the Commission should
17 disregard evidence and testimony that seek to establish that the Commission's competition rules
18 are premature, that treat competition as an option or that ask the Commission to consider the "what
19 if" scenarios as if competition were not yet. More importantly, the Commission should disregard
20 proposals that seek to insulate the Affected Utilities from the effects of competition as envisioned
21 by the Rules. The only salient facts now are those related to a rapid, balanced move toward
22 competition beginning January 1, 1999. If any proposal or aspect thereof slows the process down,
23 calls for additional regulation, or transfers the risk of future competition away from the Affected
24 Utilities and their competitors to ratepayers, the Commission must reject it. (See, Gordon, direct
25 testimony, 1/9/98, p 4, l. 2-27.)

26 In this regard, the Commission must fairly employ its own procedural and evidentiary
27 rules, and must find as fact only that which first, promotes competition and second, is supported by
28 substantial evidence. In the hearings on stranded costs, there were many ideas and opinions, but

1 the clear preponderance of the credible evidence was that stranded costs can only be rationally
2 calculated, allocated and paid using a market method. Net loss revenues or extended
3 administrative rate case-type proceedings into the future became, after December, 1996, invalid
4 methodologies.

5 Mr. Fessler testified to his concern that the restructuring rules lacked a clear vision of what
6 the Commission believes generation competition should look like. (Fessler, 2/10/98, tr. p. 548, l.
7 2-5.) Dr. Alan Rosenberg, testifying on behalf of the Arizonans for Electric Choice and
8 Competition, et. al., provided this vision as follows:

9 15 [Q.] I'd like to go through some of the
10 16 elements of what a competitive market would look
11 17 like in generation in Arizona and talk to you about
12 18 those.

13 19 In the competitive market would there be
14 20 consumer choice as between more than one provider?

15 21 A. Yes.

16 22 Q. And would those providers be efficient
17 23 providers?

18 24 A. Would they be efficient providers?

19 25 Q. In a fully competitive market.

20 [tr. p. 2225]

21 1 A. Well, yes, because if they were not
22 2 efficient providers, they wouldn't be able to stay
23 3 in competition, they wouldn't be able to stay in
24 4 business.

25 5 Q. What does efficiency mean? What benefit
26 6 does efficiency give to end users, consumers of
27 7 electricity?

28 8 A. Efficiency allows the highest output for

1 9 the least input.

2 10 Q. And does efficiency protect users,

3 11 ratepayers, from paying too much for administrative

4 12 costs, too much for overhead costs, too much for

5 13 more than the market price will really bear for

6 14 controllable costs?

7 15 A. You can think of it that way, yes.

8 16 Q. So one aspect and goal of efficiency is

9 17 to eliminate all of those costs that really ought

10 18 not in a competitive market end up in rate base?

11 19 A. That is correct. Because those producers

12 20 or suppliers that are most efficient will lower

13 21 their prices because they won't have that

14 22 overhead, other competitors will either have to

15 23 get --

16 24 Q. Get lean and mean?

17 25 A. Meet that or get out of the business.

18 [tr. p. 2226]

19 1 Q. And the business choke that is going to be

20 2 the existence of a competitive provider who isn't

21 3 efficient?

22 4 A. Right.

23 5 Q. We agree a competitive market in Arizona

24 6 would have open access, open access to the

25 7 transmission, to the distribution grid so other

26 8 generators can get through the grid down to

27 9 consumers?

28 10 A. Absolutely.

1 ...

2 24 Now, would you agree in a competitive

3 25 market most beneficial to end users there would be

4 [tr. p. 2227]

5 1 open territories, that is, any provider could sell

6 2 in any place to meet market demand?

7 3 A. That's right. There will be no protected

8 4 franchises as far as generation is concerned.

9 5 Q. Would you agree that in a competitive

10 6 market service becomes an important aspect of the

11 7 marketability of the product?

12 8 A. Yes.

13 9 Q. So consumers, residential users, would

14 10 benefit from the incentive to provide increased

15 11 service, customer service, dispute resolution

16 12 service, delivery service, again, incentive exists

17 13 in competition because that makes your product more

18 14 marketable than the fellow's product that doesn't

19 15 have that good of a service?

20 16 A. And I have seen marketing plans of

21 17 providers who intend to increase their market

22 18 share because they will provide a wide range of

23 19 services.

24 20 Q. So the actual price might not be the only

25 21 thing affecting consumer decisions?

26 22 A. Correct.

27 23 Q. And consumers, is it a benefit to

28 24 consumers to have the choice of a high service

1 25 higher cost provider than a lower cost lower
2 [tr. p. 2228]
3 1 service provider?
4 2 A. Absolutely.
5 3 Q. Is there anything in a competitive
6 4 market that will really get us there, anybody in
7 5 the regulated monopoly structure that has that
8 6 same level of incentives to higher levels of
9 7 service?
10 8 A. In my view, no.
11 9 Q. Would a competitive market need to have low
12 10 barriers to enter it?
13 11 A. Yes.
14 12 Q. Does that mean a new provider with new
15 13 technology could get in?
16 14 A. Yes.
17 15 Q. And is that barrier, the elimination of
18 16 barriers to enter, does that provide ongoing checks
19 17 against inefficient providers, high-cost providers
20 18 and so on?
21 19 A. Absolutely.
22 20 Q. Is that because anyone at anytime can come
23 21 in, and you might have to compete with somebody
24 22 from New Jersey next week?
25 23 A. Absolutely.
26 24 Q. And would you say that a competitive market
27 25 will have technological advances as part of it?
28 [tr. p. 2229]

1 1 A. I would suspect so.

2 2 Q. That is what we have seen in computers and

3 3 telecommunications after the breakup of the AT&T

4 4 monopoly?

5 5 A. That is correct.

6 6 Q. Is that a benefit to everyone, business,

7 7 consumer, residential user?

8 8 A. In my view it is, yes.

9 9 Q. Now, in your opinion does any approach to

10 10 evaluating stranded costs, other than truly market

11 11 based approach, get us there as efficiently and as

12 12 soon?

13 ...

14 17 Q. (BY MS. DALLIMORE) Get us to the

15 18 competitive paradigm we were just discussing.

16 19 A. You are asking me whether I prefer a market

17 20 based approach to administrative approach; I said I

18 21 prefer market based approaches.

19 22 Q. In your opinion, the market based approach

20 23 will get us in Arizona to a competitive marketplace

21 24 sooner, more efficiently, than the administrative

22 25 approach?

23 [tr. p. 2230]

24 1 A. My view, yes.

25 (Rosenberg, 2/18/98, p.2225-2230, as above.)

26

27

28

1 **B. The Affected Utilities are Positioning Themselves for Competition**

2
3 Dr. Gordon made it quite clear that this Commission has no role in the Affected Utility's
4 future success in competition. (Gordon direct testimony, 1/9/98, p. 8, l. 27-29.) The Affected
5 Utilities have been practicing for years how to do business in the competitive wholesale power
6 market. Affected Utilities and shareholder group witnesses alike testified that opening new
7 markets and shrewd internal management decisions about taking advantage of competition are the
8 best future protection for the Affected Utilities and their shareholders. (Davis, 2/26/98, tr. p. 3873,
9 l. 8-25, p. 3874 l. 1-2, p. 3875 l. 11-23, p. 3876, l. 1-17; Meek, 2/27/98, tr. p. 4255, l. 18-25

10 The IOUs and their shareholders have known since 1994 that competition was coming
11 and have published documents to that effect, (Meek, 2/27/98, p.4253, l. 9-11, p ; 4261. l. 14-19, p.
12 4289, l. 1-8), and have made many internal decisions to get ready, to restructure internally, and to
13 pursue new opportunities in anticipation of competition. APS is marketing retail generation in
14 Southern California this very day, and has separated its commercial operations business unit into a
15 separate accounting function from its generation business unit, so the costs of marketing in
16 Southern California can be easily determined. (Davis, 2/26/98, tr. p. 3869, l. 2-25.) TEP has a
17 retail office in Phoenix. (Meek, 2/27/98, tr. p. 4276, l. 9-11.) These moves are market-forced
18 mitigation, and have happened because of competitive pressure. Left unimpeded, these measures
19 will continue, and restructuring will happen voluntarily where it makes sense to management in
20 the new competitive environment. An example of this phenomenon is Southern Cal Edison who,
21 although required to divest only 50% of its fossil generation assets, voluntarily divested itself of
22 100%. (Fessler, 2/10/98, tr. p. 423, l. 21-25, p. 424, l. 1 -21). Southern Cal Edison figured out a
23 way to do better in the marketplace, because it had to. This is the "discipline of the market" which
24 monopolies especially lack. (Goldwater Institute direct testimony, 1/21/98, p. 11, l. 25-26.)

25 This evidence demonstrates that the Commission need not issue a draconian order that
26 substitutes its judgment about what will work for the Affected Utilities for their own
27 management's expertise. Rather, the Commission need only identify the stranded cost
28 minimizing, fast and efficient market-based method to be used. The Attorney General's suggested

1 stock value/split approach does that for APS. Voluntary divestiture or appraisal works for TEP.
2 Voluntary divestiture of above-market contracts reduced by offsetting financial gains does the job
3 for the cooperatives. The Commission will see that the companies themselves will go farther than
4 that, if they need to, to stay in the game.

5 II.

6 STRANDED COSTS MUST BE MINIMIZED TO REDUCE MARKET DISTORTION

7
8 Stranded costs do not exist in competitive markets. In competitive industries, a "stranded "
9 cost is just a loss to be "eaten by shareholders" (Goldwater Institute direct testimony, p. 12, l. 2-3.)
10 It is a management misjudgment that results in an obligation or expenditure that sales revenues
11 from market-set prices cannot cover. A cardinal principle in competition is that poor decisions
12 create immediate negative consequences to the bottom line, and that these consequences move
13 companies to better performance. Affected Utilities claim dozens of "going-forward costs" as
14 strandable, such as the "meters" development and retail marketing sought by Citizens, (Breen
15 direct testimony, 1/9/98, p. 111, l. 26-29, p. 12, l. 1-9), and the nearly unlimited costs sought by
16 APS (Hieronymus direct testimony, 1/9/98, p. 7, l. 11 to p. 9, l. 9), including "power supply
17 costs,"² "O&M Costs including A&G allocation" and other post-1996 non-generation costs "to
18 implement retail competition" sought by APS (Davis, direct testimony, p. 6, l. 20-21; Schedule
19 JED-2, l. 18;), together with future guaranteed rates of return. (Davis, 2/26/98, tr. p. 3707 l. 1-8.)

20 The very idea of paying for future operating costs is an anomaly wholly inconsistent with
21 the entire premise of this proceeding. TEP's own witness says as much. (Gordon, direct
22 testimony, 1/9/98, p.4, l. 23-26; p. 15, l. 14-16). It is clear that some of the Affected Utilities
23 have no concept of how to, or intention to, discipline themselves as to their costs in competition.
24 The Commission should keep in mind that letting the market discipline the future is a desirable

25
26
27 ² Apparently these costs are to be paid by APS ratepayers even if they are incurred in the
28 future to supply power to the Southern California retail markets APS is entering or the SRP
markets APS intends to enter. (Compare Davis direct testimony, 1/9/98, Schedule JED-2, l. 15-21,
to Davis' testimony, tr. p.3896, l. 16-19.)

1 goal, not an unfair punishment.

2 Paying stranded costs, whatever the theory, puts an artificial cost (not generated by supply,
3 demand and marginal cost factors) on doing business and necessarily distorts markets by, among
4 other things, artificially altering consumption. (Block, 2/25/98, tr. p. 3464, l. 13- 23.) This cost,
5 the so-called CTC, is a cost paid by consumers (or new market entrants) for essentially nothing but
6 the privilege to choose a provider. The higher these artificial costs, the higher prices will be, since
7 even efficient firms cannot drive prices all the way down to their own marginal costs. Everyone
8 has to charge and pay the extra price. The paramount goal then, is to pay as close to zero stranded
9 costs as possible, and therefore to choose the method of calculation that will justify the lowest
10 stranded cost recovery.³

11 **A. If there is No Lost Shareholder Equity, there are No Stranded Costs**

12 Shareholders are, of course, the real "owners" of the investor owned utilities, APS, TEP
13 and Citizens. (Meek, 2/27/98, tr. p. 4251, Block, 2/25/98, tr. p.3551, l. 21-25, 3552, l. 1-8; Davis,
14 2/26/98, tr. p. 3827, l. 14-15). With or without the "regulatory compact" theory⁴, the only
15 rational justification for stranded cost recovery is the view that the owner/shareholders have lost
16 the equity they enjoyed, or the opportunity to recoup a fair rate of return if things go well, not
17 because of any management decision or market event, but because the regulators have changed the
18 entire utility environment by moving to competition. (Block, 2/25/98, tr. p. 3551, l. 21-25, p.

19 _____
20 ³ Mr. Fessler testified that avoiding litigation was a primary reason for paying
21 STRANDED costs. (Fessler, 2/10/98, tr. p.461, l. 12-18.) Dr. Block said that recognizing a duty
22 to pay STRANDED costs was merely a way of resolving the utilities' claims so that the process
23 could move forward. (Block, direct testimony, 1/9/98, p. 12, l. 22-24.) These are important goals.
24 The Attorney General is not advocating zero STRANDED costs if in fact shareholders have lost
25 any portion of their investment. But where a market-based method shows no real loss "due to
26 competition", and payment of STRANDED costs with its negative consequences to ratepayers and
27 competition would amount to a future hedge for the company against competition, none should be
28 awarded. Affected Utilities will pursue their remedies if they are dissatisfied whatever the
Commission does. TEP has already threatened to sue. (Bayless rebuttal testimony, p. 5, l. 4-5.)
Small ratepayers will not be able to resort to the courts. The proper balance is not to pay the
utilities everything they want to avoid litigation, but to base the minimal award squarely upon
verifiable proof on how much competition (i.e., the free market) has actually cost the investors as
of the time the change goes into effect.

⁴ There is little support for this theory in law or in economics. The regulatory compact is a
weak justification for STRANDED costs. (Dr. Coyle, 2/11/98, tr. p. 1101.)

1 3552, l. 1-23; Goldwater Institute direct testimony, 1/21/98, p. 9, l. 4-11.)

2 APS and TEP appear to accept this basic premise, but thereafter their reasoning fails. They
3 equate the “**opportunity**” to recover 100% of stranded **investment**, to the “**guaranteed**” recovery
4 of the **future revenues and rates of return** they expected in a continued regulatory environment.
5 (See, Meek, 2/27/98, tr. p 4260, l. 23-25; p. 4261, l. 1-7; Davis, e. g., 2/26/98, tr. p.3707, l. 1-8;
6 Bayless, direct testimony, 1/9/98, p. 6, l. 15-21.) TEP’s expert says only that the utilities’ owners
7 are entitled to a “reasonable opportunity” to recover “100 percent of those shareholder funds that
8 they have **invested in plant and equipment** that may be strandable owing to the Commission’s
9 decision to introduce competition in Arizona” (Fessler, 2/10 /98, tr. p. 458, l. 19-21; but also that
10 recovery itself “was never a 100% guaranteed result”, (*id.*, p. , l. 9-10). TEP’s expert
11 conclusively states that future gains, profits and losses (other than continuing Commission
12 mandates) are no part of the stranded costs equation. (Gordon, direct testimony, 1/9/98, p. 12, l. 9-
13 12.)

14 It follows from this evidence that the Commission can lawfully award shareholders only
15 that amount of stranded costs that repairs their lost equity as of the moment when the change in
16 regulatory environment impacted the investment. The result is the same considering the
17 Commission’s past orders awarding the shareholders a reasonable rate of return. Another line of
18 reasoning postulates that what the shareholders gave up by investing in utilities⁵ was their
19 potential for the big rewards the market sometimes offers. (Block, direct testimony, Exh. GWI 1.
20 p. 9, l. 6-8, *quoting, Economic Report of the President*, 1996.) In exchange, they got a good,
21 steady rate of return from having to wait to recover the value of their original investment. APS
22 and TEP have skewed this argument and claim that therefore those gains must continue at least
23 until the “market imbalance” is over in 2006. (Davis direct testimony, 1/9/98, p. 10, l. 10-20.)
24 This view misses the point that if the equity is unimpaired, that is, if the shareholders have or will,
25 (through divestiture sales prices or elevated stock values) recover their investment, they are whole
26

27
28 ⁵ If in fact anything was given up, given that at least some utilities have been among the
best investments to be had over the last few years. (Exh. A.G. 4)

1 and everything else is irrelevant .

2 Moreover, if the shareholders have already reaped their just rewards, because their equity
3 is not impaired by the move to competition, there are no stranded costs. Any measure of stranded
4 costs that rewards management for inefficient costs, that preserves a future competitive position or
5 market share, or that protects the equity position of the shareholders going forward from the effect
6 of competitive market prices overcompensates shareholders to the detriment of ratepayers and
7 potentially taxpayers. Giving shareholders the **chance** to get back what they actually invested in
8 “bricks and mortar”, plus a rate of return on that amount only over the period their recovery of
9 those investments was deferred fully keeps any promise the government allegedly made.
10 Conversely, awarding any fixed or guaranteed revenue stream or rate of return into the future is
11 not supported by substantial evidence in this record and would therefore be an abuse of the
12 Commission’s discretion. See, *Pima County v. Pima County Merit System Com’n*, 189 Ariz. 566,
13 944 P. 2d 508, (App. 1997); *Havasu Heights Ranch and Development Corp. v. Desert Valley*
14 *Wood Products, Inc.*, 167 Ariz. 383, 386- 387, 807 P. 2d 1119, 1122-1123 (App. 1990).

15 Indeed, such a ruling would be contrary to the law argued to support the regulatory
16 “taking” premise of the alleged compact. **An economic loss from competition**, even where it
17 reduces investors’ expected return, and even if it is allegedly unfair competition by the
18 government, **is not a constitutional “taking.”** *Laidlaw Waste Systems, Inc. v. City of Phoenix*,
19 168, Ariz. 563, 565-567, 815 P. 2d 932, 934-936 (App. 1991). A reasonable opportunity to
20 recover the value of property “taken” by government is, in the constitutional sense, only an
21 “adequate process for obtaining compensation”, not a fixed amount of money. The “adequate
22 process can be, as it is in this docket, a process provided by a State. *Williamson County Regional*
23 *Planning Comm’n v. Hamilton Bank of Johnson City*, 473 U.S. 172, 194-95, (1985).

24 The “reasonable opportunity” for APS to recover 100% stranded costs is the chance,
25 through this proceeding and the Commission’s order, for its shareholders to **keep** the fantastic
26 gains that the company has been able to retain by undoubtedly brilliant management. It is
27 indisputable that APS management has done well for its shareholders in the face of looming
28 competition:

1 12. Q. (By Ms. Dallimore of Mr. Meek) Are you aware, at the beginning of 1995
2 13. and the end of 1996, when the rules were made final in
3 14. this Commission, that APS stock gained \$688 million
4 15. in value?

5 16. A. I'm glad to hear it.

6 17. Q. Does that sound right to you?

7 18. A. That sounds fine to me.

8 19. Q. And are you aware of the fact that since

9 20. the rules were made final in December of 1996, the

10 21. stock has gained 28 more percent in value? Are you

11 22. aware of that?

12 23. A. I'm not completely aware of it, but again,

13 24. I'll accept that.

14 25. Q. And I think you told me, didn't you tell me

15 [p. 4254]

16 ...

17 4. Q. Were you aware of the fact, between December 1996, when this

18 5. Commission finalized its rules subjecting APS to

19 6. competition, the stock gained \$946 million in

20 7. value?

21 8. A. I'm not aware of that specifically, but

22 9. again, I'll accept that.

23 (Meek 2/27/98, p. 4253-54; Exh. A.G. 4.)

24 A gain of \$1.3 billion dollars in value since it was known in the industry that competition
25 was coming is a pretty darn good return. The Attorney General proposes that the Commission let
26 the APS/Pinnacle West shareholders keep the gain by valuing the stock as proposed, and to let
27 APS get on with its in-place plans to compete, subject only to restrictions on abuse of its retail
28 market power in its historic monopoly territory.

1 Of course APS's shareholders, a substantial number of whom are APS executives, want
2 more. Mr. Meek just assumed the 11.25% rate of return for investors was built into APS's net
3 revenues lost recovery program, and lauded it as "protecting their investment". (Meek, 2/27/98, tr.
4 p. 4261.) Mr. Davis made it clear that APS wants to guarantee revenues to pay all costs plus this
5 11.25% to shareholders (including himself) for eight more years. (Davis, 2/26/98, tr. p. 3707, l. 1-
6 8.)

7 This Commission has neither the duty nor the authority to "protect" anyone's above-book
8 value investment. In fact, the Commission has a responsibility, in advancing competition, to
9 award zero stranded costs where huge gains in equity have occurred. APS and its parent, Pinnacle
10 West, have done a remarkable job of making that company profitable at a time of dramatic market
11 change. There is no reason they would not continue to do so. Although Mr. Meek opines that
12 capital will dry up" if the commission issues an order for less than 100% stranded costs, his
13 opinion is completely contradicted by the dramatic increase in the value of the APS/Pinnacle West
14 stock **after** the market investors knew that on January 1, 1999, competition would begin. (Meek,
15 tr. p. 4254, l. 4-10.)

16 There is no evidence before this Commission that the shareholders of Pinnacle West have
17 lost, or will lose, anything.⁶ Mr. Meek's dire prediction is not "substantial evidence" that the stock
18 market methodology will result in less than 100% stranded cost recovery. There is no such
19 evidence in this record. This Commission must not only have at least substantial evidence on
20 which to base its findings to avoid a reversal on appeal for abuse of discretion, the party
21 advocating a fact must prove it by a preponderance of the evidence. *Culpepper v. State*, 187 Ariz.
22 431, 435-438, 930 P. 2d 508, 512-515 (App. 1997). On this record, therefore, the Commission
23 cannot charge ratepayers one cent for stranded costs for APS. The best it can do for APS/Pinnacle
24 West shareholders, is to order that they have recovered more than stranded costs, and are fortunate
25

26 ⁶Using the Attorney General's stock market approach, the Commission's order would grant
27 APS's shareholders 100% of their STRANDED costs by allowing them to keep their elevated
28 values. Even if the market reacted negatively to the Commissions' order, under the Attorney
General's proposal, the shareholders would be paid for the loss caused by the actual change to
competition. (Lopezlira, direct testimony, Exh. A. G. 1, p. 8, l. 13-20.)

1 enough to keep the change. Any other order is clearly subject to reversal on appeal.

2 This form of having one's equity cake and eating it too, in the form of a guaranteed rate of
3 return not subject to the effects of competition, became a common theme in the stranded costs
4 testimony. As to other Affected Utilities, their net revenues lost approach, or their failure to offset
5 the value of new market opportunities or other gains against stranded "losses" suffers from the
6 same logical flaws as does APS's plan, although their equity owners may not have fared so well.
7 The Commission may not lawfully protect any utility's position "going forward".

8
9 **B. Where Loss of Equity is Possible, the Loss must be Measured by Offsetting Net**
10 **Gains against Net Losses**
11

12 The right, (in fact the only), determination of the stranded cost question as to APS
13 shareholders is clear. Less clear is the question of how to handle TEP whose shareholders have
14 not fared so well, and Citizens, to whom electric generation is a minor side-line to its principal
15 business. Given the testimony in this record, it is evident that the stock valuation approach will
16 not work for these two IOUs. However, divestiture of generation assets will work for TEP, and,
17 with the offset of restructure gains, for Citizens.

18 As to TEP, the stock valuation method will not paint a reasonably accurate picture of
19 what shareholders have lost due to competition, as compared to what they have lost because of
20 management error. TEP's stock already suffered from mismanagement, and it would be nearly
21 impossible to sort out in this proceeding how much of an effect, if any, the threat of competition
22 has affected its value. Further, the 90% debt load TEP carries cannot be ruled out as the cause for
23 the loss of equity.

24 As has been shown, the right method for any Affected Utility is the one that minimizes
25 stranded costs. For TEP, that method is clearly divestiture of generation assets. These depreciated
26 assets, for example the Springerville plant could, in the current generation market environment,
27 actually net book values or more, which would inure to the benefit of TEP's equity shareholders.
28 A willing buyer will in fact consider the current financial position of TEP and how that affects the

1 power plant. A buyer will consider the value of the plants within his own scheme, and will
2 determine how to make it profitable. His offer, therefore, will reflect the highest and best value
3 the asset can achieve, and will correctly sort out what has going-forward value and what does not.
4 This scenario is exactly what Dr. Block meant when he testified that the people with a financial
5 stake in the outcome are best suited to assess the values of assets, and to obtain those values
6 without regulatory involvement. (Block, 2/25/98, tr. p. 3469, l. 10-25, p. 3470, l. 1 -14.)

7 Citizen's shareholders face a different set of circumstances, but Citizen's planned
8 divestiture should be well received. Citizen's proposed divestiture of the long term above-market
9 power contracts with APS will surely improve its financial position. Citizen's stock is likely to
10 rise upon that event alone, irrespective of the award of stranded costs, although the stock valuation
11 change on the divestiture would be difficult to assess given that electric generation is not Citizen's
12 core business. Citizens wants to be rid of a contract that is like a bad debt, taking whatever it can
13 get from the sale in cash, and charging the difference to ratepayers. But Citizens' plan does not
14 propose to offset the divestiture-enhanced equity the divestiture would create against the
15 "stranded" loss. The record as to Citizen's situation supports divestiture, but does not support the
16 calculation of stranded costs as the difference between the cash price of the APS contract and the
17 cost of wholesale power without considering the offsetting gains from reselling cheaper wholesale
18 power. Losses must be netted against gains to avoid burdening the market with an overpayment to
19 Citizens.

20
21 **C. No Rational Economic or Legal Theory Mandates Payment of All Generation**
22 **Costs**

23 If the market sets the selling price, what then sets the cost? Under APS' and TEPs plans,
24 the market is critical in establishing wholesale price, but becomes irrelevant when it comes to
25 costs. In a competitive market, a company whose marginal cost is greater than the market price
26 cannot survive. Yet APS and TEP want the Commission to require **ratepayers to pay all**
27 **generation costs** until 2006 or later with no questions asked, no matter how high the marginal
28 costs, no matter how imprudent, taking on faith that the cost is a true cost of generation. This, says

1 Mr. Davis, is a plan based on "actual costs" and "market prices." (Davis direct testimony, 1/9/98,
2 p. 11, l. 9-10.) Under these plans, the cost of production becomes totally divorced from the price
3 a willing buyer will pay, and the management bonuses, and shareholder rates of return become a
4 ratepayer-funded free ride.

5 Moreover, under these plans, the "market" chosen to dictate price is the wholesale market,
6 essentially the lowest price at which power in the open market can be sold. The true retail market
7 price, measured by any means, is considered irrelevant. This pick-and-choose method of using the
8 market when it is convenient insures that the "stranded" loss will be as high as any set of numbers
9 can make it, completely disregarding the essential point of allowing the "genius of the
10 marketplace" to drive all firms to maximize efficiencies to produce at the lower market prices the
11 competition has generated.

12 The efficiency benefit of the competitive market is the truest reason for moving toward it.
13 Everyone who testified in the hearings admitted that efficiency is a desirable goal and said his or
14 her plan included "incentives" to become efficient. TEP's expert Dr. Gordon perhaps best
15 expressed the concept:

16
17 3 And I think that what that is informed
18 4 by the kind of regulation that has gone on in the
19 5 past where rates are set so that you will only make
20 6 your allowed rate of return in a traditional
21 7 system, you know, if the management stretches
22 8 itself, exercises full capability, meets its
23 9 responsibilities in terms of being efficient, being
24 10 prompt, being responsive and the like. If you
25 11 don't meet those then you won't get it. You had
26 12 your reasonable opportunity, but you didn't get it,
27 13 so that has that philosophy, is what should apply
28 14 in the case of stranded cost recovery as well.

1 (Gordon, 2/10/98, tr. p. 737, l. as above)

2
3 It behooves the Commission to sort the true market-driven efficiency incentives from those
4 that merely add to costs. In the APS plan, the "incentives" to economize are management bonuses,
5 (Davis, 2/26/98 tr. p. 3763, l. 19 -25), to be guaranteed by ratepayers, along with the 11.25%
6 shareholder rate of return whether or not APS gets its real generation costs any closer to the
7 wholesale or retail market price of power.

8 Thus, in the "cost-plus" net lost revenues plans, costs are separated from real market
9 earnings, and the most powerful cost-cutting incentive of all, that revenues will not be enough to
10 pay for the cost of generation, is eliminated completely. This severance is unheard of in
11 competitive markets, and is completely contrary to the Commission's goal of instituting retail
12 competition.

13
14 15 [W]hen you have cost plus
15 16 regulation, you do tend to get inefficient costs
16 17 because you don't have the discipline of a
17 18 marketplace and any commission, no matter how well
18 19 staffed or how competent, is not in the same
19 20 position to impose the same discipline that an
20 21 efficient competitor will impose. I think there
21 22 was a chief executive of a utility once said the
22 23 only business in the world where I can increase my
23 24 profits is by remodeling my office.

24 (Rosenberg, 2/18/98, tr. p. 2331; *see also*, Gordon direct testimony, 1/9/98, p. 15, l.
25 12-16.)

26 Of course the Affected Utilities net lost revenues plans do much more than afford a
27 reasonable opportunity to recover stranded costs. Net loss revenue is merely a cash flow
28 guarantee and, as such, is a tremendous barrier to competition. Using this methodology would

1 over-compensate the Affected Utilities, drive the retail price of power higher, preserve existing
2 market power even for inefficient firms, delay technological advances and generate artificial cash
3 flows to subsidize retail prices for incumbents thereby thwarting the delivery of truly cheaper
4 power from efficient providers to the Arizona retail market. These plans create almost
5 insurmountable barriers to entry, and wholly thwart the Commission's plan for competition. This
6 Commission cannot, under its own rules, adopt the Affected Utilities net lost revenues plans. By
7 adopting this approach, the Commission would be guaranteeing the market position of the affected
8 utilities by insulating them from competition.

9 This may be the reason that APS's counsel attempted to set up a legal estoppel or waiver
10 argument to force net loss revenues upon the Commission. The ploy was to have former Utilities
11 Director Carl Dabelstein pretend to be an ordinary citizen appearing "pro per", and then to testify
12 as an expert former Utilities Director that the "true" position of the Commission staff is foursquare
13 in support of net loss revenue. Dabelstein, of course, was the employee of TEP before he became
14 Utilities Director, (Dabelstein direct testimony, 1/9/98, Appendix A, p. 2, l. 26-29, p. 3, l. 1-3) and
15 clearly never lost the bias he necessarily developed there.

16 Because of this bias, Dabelstein testified under false pretenses and claimed that he invited
17 all parties to have their say in the Stranded Cost Working Group and no one successfully
18 challenged his personal endorsement of net loss revenue. (E.g., Dabelstein, 2/12/98, tr. p. 1462 -
19 1478 .) The Stranded Cost Working Group Report was admitted over the objection of many other
20 parties, for the potential purpose of "impeaching" the testimony of staff which has rightly adopted
21 a much less radical, more market-reality based proposal. The report itself belies Dabelstein's
22 testimony that the document was a product of some consensus. (*Id.*) Neither the report nor
23 Dabelstein's personal preference for net loss revenue should be considered substantial evidence of
24 its validity as an option for the commission.

25 The net loss revenue approach is neither consistent with the Commission's rules nor with
26 the so-called "regulatory compact" the Affected Utilities rely on. Indisputably, overcapacity in the
27 generation product market is the cause of "strandable" costs. (Davis direct testimony, 1/9/98, p.
28 10, l. 12-14.) Overcapacity, that is, excess supply, always drives prices down, as it has done in the

1 wholesale power market. This in turn means that needed megawatts can now be obtained in the
2 wholesale market more cheaply than the cost of their generation. This is the environment into
3 which the Commission ⁷ has already decided the Affected Utilities must operate. Having so
4 determined, the Commission cannot now change the nature of stranded costs to make them future
5 revenue guarantees.

6 Any "going-forward" cost of operation is not, prima facie, a "stranded cost". (Gordon,
7 direct testimony, 1/9/98, p.8, l. 26-29; p. 12, l. 9-12.) With the exception of the lost "brick and
8 mortar" investment costs to be determined by a market measure of equity value, and the continued
9 duty to serve obligations, no cost incurred after January 1, 1999 is a "stranded cost". Thereafter
10 these are costs of doing business in a competitive world. If the costs are too high, then losses may
11 indeed occur. However, this Commission cannot lawfully "compensate" losses caused by
12 competition, even by government-forced competition. *Laidlaw Waste Systems, Inc. v. City of*
13 *Phoenix*, 168 Ariz. 563, 565-567, 815 P. 2d 932, 934-936 (Ariz. App. 1991), *infra*, at p. 15.

14 Net lost revenue, in the form advocated by TEP, APS, AEPCO, Navopache Cooperative
15 and AUIA, is essentially a guarantee of profitability that compensates largely for expected future
16 losses caused by competition. Once the investors are sure they have received the equivalent of
17 their investment, the responsibility of this Commission and of the ratepayers ends. At the time the
18 assets are valued, the extent to which investors are willing to take this risk will be measured and
19 compensated as appropriate. Thereafter, their gains and losses will be driven by the fluctuations of
20 markets, and subject, as in other industries, to changes in regulatory regimes and management
21 decisions that may cost them money. This is simply a shareholder risk in capitalist markets,
22 where no investor can reasonably expect to have his capital gains and fixed rate of returns paid in a
23 competitive environment.

24 The Attorney General's view is that the independent shareholders and stock-owning
25 company executives are entitled to keep the above-book equity that internal restructuring or savvy
26

27 ⁷ And, it would appear, the Arizona legislature, which is likely to pass an amended version
28 of House Bill 2663, deregulating public power generation and seeking continuity with the
Commission for public service corporations.

1 management nets. They should absolutely not, however, be insulated from the future effects of
2 competition on cash flows or rates of return. Every net lost revenue method advocated in this case
3 proposes taking money from ratepayers unnecessarily, adding stranded cost charges which will
4 artificially elevate retail electric rates and raise costly barriers to new competition.

6 III.

7 THE OVERWHELMING PREPONDERANCE OF THE EVIDENCE PROVES THE 8 SUPERIORITY OF A MARKET-BASED METHOD OF CALCULATING STRANDED 9 COSTS

11 A. Reliance on Market Values is Inherent in Every Stranded Costs Plan

13 1 [A. by Mr. Meeks: I] don't know how the market feels about APS or TEP's
14 2 ability to compete, and that's what it will boil
15 3 down to.

16 4 Q. It demonstrates, isn't it true, that the
17 5 only entity who does know is the market?

18 6 A. I would say that's probably true.

19 (Meek, 2/27/98, tr. p. 4265, l. as above.)
20

21 A recurrent theme in the stranded cost hearings has been that the Commission should leave
22 decisions about market values to those best suited to decide such questions. The Attorney
23 General, APS, AUIA, the Goldwater Institute, Citizens, and the major competitors and virtually
24 all the economists agree that management is best suited to make management decisions.

25 As Dr. Block said, those who have their own money at stake will make the shrewdest
26 decisions possible. Those who invest in utilities⁸ and those who buy power plants and power
27

28 ⁸ Some of whom, Mr. Meek finally admitted, may indeed be part of the "Gucci" crowd.

1 contracts for a living, will in every case have better information about the transaction before
2 entering into it than the Commission is likely to have. Mr. Fessler described this phenomenon
3 when he talked about the divestiture certain California utilities voluntarily commenced, even
4 without a Commission mandate. (Fessler, 2/10/98, tr. p. 423, l. 21-25, p. 424, l. 1 -21.)

5 Those who have no financial stake in the outcome will more often than not be mistaken.
6 Regulatory, administrative, estimate-based determinations are called suspect even by those who
7 recommend them. Former Utilities Director Dabelstein cited the need for true-ups in connection
8 with "administratively determined stranded costs" because:

9 There is considerable uncertainty in attempting to quantify stranded costs.

10 The process is based on a number of factors that, at this point, are nearly
11 impossible to predict. **It is pure speculation** to project what the markets
12 and prices for power will be in the future.

13 (Dabelstein direct testimony, 1/23/93, p. 20, l. 1-5.) Presumably Mr. Dabelstein has no problem
14 with the fact that the ratepayers pay for these exercises in "pure speculation". (Davis, 2/26/98, tr.
15 p. 3884, l. 7-21.)

16 It may indeed be "nearly impossible" for Mr. Dabelstein to predict market behavior, but a
17 sophisticated buyer of a power plant knows what questions to ask. Mr. Davis is quite sure he can
18 predict the future of the market with sufficient certainty to intelligently buy a power plant (e. g.,
19 Davis, 2/26/98, tr. p. 3887, l. 13-25, p. 3891, l. 1-25, p. 3891, l. 1) and to estimate the precise year
20 that the industry's long-run marginal cost of generation will intersect with the market price.
21 (Davis direct testimony, 1/9/98, p. 10, l. 16-18.)

22 The Attorney General's approach proposes to leave management to management,
23 investment and capital decisions to the financial markets, and power plant and power supply
24 contract prices to the give and take of sophisticated buyers and sellers. The Attorney General is
25 hardly a voice crying in the wilderness. Every proposal in this proceeding contemplates relying,
26 in whole or in part, on this vast (and free) storehouse of personal-interest expertise.

27 This is because the Commission can't get to "stranded" costs without relying on a
28 "market". Every witness in this proceeding relied on some market or another in endorsing a

1 method of calculating stranded costs. APS's method of net lost revenues would measure costs
2 against the California PX wholesale market price index. (Davis direct testimony, 1/9/98, Schedule
3 JED-2, l. 6.) TEP would use the Dow Jones Palo Verde Index. (Bayless direct testimony, 1/9/98,
4 p. 14, l. 23-24.) Citizen's would tap the short-term willing buyers of power sources market.
5 (Breen, direct testimony, 1/9/98, p. 14, l. 8 -14). AEPCO would rely on the "market price", if it
6 falls relative to its own price, to define its possible stranded costs. (Edwards, 2/17/98, tr. p. 2039,
7 l. 23-25, p. 2040, l. 1-2.) Dr. Cooper testified that the basic function of regulation is to "mimic the
8 competitive market". (Cooper, 2/19/98, tr. p. 2453, l. 11-15.) RUCO's Dr. Rosen would use the
9 "market price of generation" to determine the stranded cost to be apportioned to a particular
10 consumer class. (Rosen, 2/17/98, tr. p. 1816, l. 10-18.) The industrial ratepayers' expert Dr.
11 Rosenberg uses market values to test book values. (Rosenberg, 2/18/98, tr. p. 2189, l. 19-25, p.
12 2190, l. 1-2.) Other parties and experts rely on various market measures. Even Mr. Dabelstein,
13 the most avid administrative devotee, feels compelled to rely on market prices to estimate annual
14 revenues in his version of net loss revenues. (Dabelstein prefiled testimony, p. 8, l. 22-29, p. 9, l.
15 1-10.).

16 Mr. Fessler described how in California, following great frustration, the legislature
17 intervened and forced divestiture. The reason for this dramatic step is that there is no way, other
18 than reliance on the market, to achieve the results the market can generate. Ms. Petrochko of
19 Enron described how in the PECO stranded costs proceedings, the regulators settled upon a rate
20 reduction, which the competitor, Enron, promptly doubled in order to secure residential customers.
21 (Petrochko, 2/12/98, tr. p. 1002, l. 7 - p. 1005, l. 10).

22 The administrative approach is merely a proxy for the relevant markets. This Commission
23 should adopt the simplest method of allowing the markets to speak the most directly, and get on to
24 the real point of its restructuring Rules.

25 **B. Only A True Market Determination of Value is Fast, Efficient and Offers Market**
26 **Certainty**

27 The Commission's intent is to start competition by 1999, and have it fully implemented by
28 2000. No administrative method can meet that deadline. If the stranded cost hearings are any

1 indication, there will not be enough time to complete even part of that plan by the end of 1998.
2 Moreover, no one will really know what the CTC is going to finally be, or how much money this
3 will cost ratepayers, for years.

4 RUCO's administrative approach will take fifteen (15) years or more to play out. Dr.
5 Cooper may have the math right about when the stranded costs will become negative and the
6 ratepayers can make back what they lost, but by then the harm to the budding competitive market
7 will have been done. APS's plan for guaranteed revenues extends out seven (7) years, to the end
8 of what APS calls the "market imbalance period. (Davis, direct testimony, 1/9/98, p. 3, l. 7-8, p.
9 10, l. 16-18.) By then, new technology may make gas plants obsolete and even power poles
10 irrelevant.

11 The great weight of the evidence, from those who understand how competitive markets
12 work, proves that the method, and the number, must be set now, this year. The payout term can be
13 five (5) years long, but the uncertainty will prevent the true benefits of competition in the
14 meantime. (Nelson, 2/27/98, p. tr. 4183, l. 16-25, p. 4227, l. 14-18.)

15 The most compelling argument for adopting a stock or divestiture or appraisal valuation
16 plan, is that there is a short-term "buyers' market" phenomenon existing now. (Breen, prefiled
17 testimony, 1/9/98, p. 14, l. 80-14.) For probably no more than two (2) years, TEP might be able to
18 get book-plus for its generation assets. As new markets open in deregulating states, many parties
19 will want to own capacity to get in on the new retail ground floor. If the Commission waits, or
20 adopts a long-term "let's see how this works for a while and look at it again later methodology", it
21 will have cost ratepayers millions of dollars. There is no evidence in this record that the best
22 market for the sale of generation assets (aside from nuclear) is any time but now. The
23 Commission cannot, on this record, rule that short-term market valuations are not in the best
24 interests of the ratepayers, big and small. It is the Commission's duty to protect those ratepayers.

25 **C. Fairness Requires A Market Approach**

26 It is difficult to see how TEP can claim, as Mr. Carroll did in his opening statement, (2/9/98
27 tr. p. 77, l. 16-22), that only the affected utilities and their shareholders have something to lose.
28 Everyone has something to lose in this proceeding if the Commission's order goes too far one way

1 or another.

2 Only the market approaches minimize the risk of overcompensating the Affected Utilities.
3 Whether or not deregulation involves a "regulatory compact" breach, it certainly at some point
4 involves a taking of someone's property, but the taking is not limited to utility investors or
5 cooperative owners. Overcompensation would be a truly improper transfer of wealth from
6 ratepayers to affected utilities and their shareholders, as to whom the commission has "by a
7 relationship developed over time ... created the legitimate expectation", (Fessler, 2/10/98/ tr. p.
8 512, l. 17-19), that the Commission will not pay more to the utilities than they are entitled to.
9 Thus, by the reasoning of the parties basing their claims on a "regulatory compact" the
10 Commission's unjustified transfer of wealth from ratepayers to insulate the utilities from
11 competition would itself be an unlawful "taking".

12 The Attorney General does not argue that there is a "regulatory compact". However, there
13 are government promises made to consumers, business big and small and, in this venue, to all
14 ratepayers too, which include that there will be no such transfer of wealth. The regulatory compact
15 of monopoly utility regulation, if there is one either *de facto* or *de jure*, is as much a promise to
16 shield consumers of electricity from the windfall profits that monopolies necessarily can achieve,
17 in exchange for the ratepayers' covenant to pay the bill, as it is to protect utility investors from the
18 risk of equity loss. Thus fairness demands that, while utility investors do not have their
19 investments rendered valueless by deregulation, ratepayers not pay more for "strandable" costs
20 than the equivalent of asset book value.

21 To avoid overvaluing the shareholders' claim to net loss revenue as essential to "fairness",
22 the Commission should keep in mind that there is **no independent shareholder** testimony before
23 it. Mr. Meek is a good witness for APS, and APS management stands to gain greatly from the
24 approach Mr. Meek supports, but, by his own admission Mr. Meek on behalf of the Arizona Utility
25 Investors Association is merely a shill, a counterfeit counterweight to RUCO, whose efforts before
26 the commission on electricity matters are completely paid for by APS, and whose association with
27 APS is concealed in marketing literature. (Meek, 2/27/98, tr. p. 4281, l. 16-25 through p. 4284, l.
28 1-12; Exhibit AECC, et. al., #6.) Mr. Meek, therefore, cannot be heard to speak for fairness to

1 shareholders who also hold stock in competitors of APS.

2 What is "fair" is what the market does. No one would argue that a person who finds that he
3 cannot get his asking price on the sale of his home is treated unfairly by the system, and is entitled
4 to government relief. The market (the stock market, the retail power market, or the generation
5 asset market) will necessarily generate "fair market value". Indeed this is the only fair "market"
6 value there is.

7
8 **D. Capital Will Not Dry Up if a Market Approach is Used**

9 "It is entirely appropriate in my opinion -- indeed desirable -- to change *on a forward going*
10 *basis* to a framework in which the **risk of prospective investments will be placed entirely on the**
11 **shareholders....**" (Gordon, direct testimony, p.8, l. 26-29.)

12 The Affected Utilities, other than Citizens, prediction that, without application of their
13 version of net loss revenue to stranded costs, capital will dry up, is a red herring. In his prefiled
14 testimony, Mr. Meek predicts the end of capitalism as we know it, if 100% of stranded costs are
15 not recovered. Yet he also agreed that APS/Pinnacle West stock rose \$946 million dollars after
16 the Commission determined to open generation to competition. The financial markets (driven by
17 people who have their own money at stake) have already decided that APS is a good investment
18 even with competition coming, and capital has rained from the sky upon the company and its
19 shareholders. (Exh. A.G. 4.)

20 The same can be said about the above-book sales of generation assets. These above-book-
21 value buyers may be "suckers" to use Mr. Meek's vernacular, or they may be geniuses ahead of
22 their times. Either way, right now capital is raining down upon companies with generation assets
23 up for sale. The Commission must recognize from the testimony in this proceeding that now is as
24 good a time to sell power plants as there is likely to be.

25 It may be true that an Affected Utility feels a particular type of capital may be at risk (such
26 as new, low-interest debt refinancing). This does not mean that capital will dry up, or that
27 ratepayers and competition must pay for the best deal in capital availability. And, there are
28 situations where easy capital is already hard to find. The hard truth, and the truth to which

1 ratepayers are entitled, is that TEP cannot now attract the kind of capital it needs to stay profitable
2 in the competitive retail market. TEP, like any other strapped company, may have to sell to get
3 cash to pay its bills, and, if one of its generation assets "cannot recover its avoidable cost, [TEP]
4 can be expected to close it." (Hieronymus direct testimony, 1/9/98, p. v22, l. 11-12.) If it sells
5 soon, TEP may even net a gain for its investors.

6 Ratepayers simply do not owe the TEP shareholders a revenue stream with which it can
7 restructure debt to the liking of management, nor is that a proper purpose for which to burden the
8 competition with an inefficient, subsidized competitor with market power. It makes no economic
9 sense to perpetuate a firm that is unable to operate profitably on its own, and no substantial
10 evidence in this record would support the Commission's doing so.

11 12 **E. Market Methods Permit A Simple Process**

13 Although they have tried mightily, the Affected Utilities have been unable to really
14 complicate the market approaches. The stock market approach is so simple and works so well for
15 APS/Pinnacle West, that there is no evidentiary basis for disregarding it. No witness concretely
16 identified any actual problem in terms of cost or delay occasioned by a simple coupon split off.
17 The witnesses who touched on the mechanics of this approach said this was the most expeditious,
18 simplest and most cost-effective measure. (Goldwater Institute direct testimony, 1/21/98, p. 12, l.
19 22-24; Lopezlira rebuttal testimony, 2/4/98, comprehensive summary, p. 2.) Of course, there has
20 been such a meteoric rise in shareholder equity for APS/Pinnacle West (Exh. A.G. 4), that there
21 are zero STRANDED costs. The costs of administering the zero repayment will likewise be zero.

22 Divestiture for TEP and Citizens and the other cooperatives can be effected by a very
23 simple set of rules as follows:

24 1. Prepare a request for proposals by a date within ninety (90) days of the
25 Commission's order, seeking offers to purchase the identified asset(s) which sets forth
26 acceptable terms such as:

- 27 a. Reasonable payment form and duration
28 b. Financing options

1 c. Time frames to closure

2 2. Require that proposals be returned by a date certain within ninety (90) days.

3 3. Require that bidders be independent of the selling entity.

4 4. Prohibit acquisition by any entity holding market power in generation or distribution
5 in a certificated geographic area in Arizona.

6 5. Sell to the highest responsible bidder upon obtaining regulatory approvals but no
7 later than a reasonable date certain. If the sale cannot close before the end of 1998,
8 the values generated by the sale can nevertheless be determined by that time.

9 An appraisal method can likewise be rapid and efficient. The Commission can order the
10 retention of a panel of three expert appraisals, one chosen by the Affected Utility, one by the
11 Commission and the third by the other two. These appraisers would be directed to finish the job
12 by a date certain before the end of 1998.

13 Where the greatest return from the divested asset is the financial gain from the reduction of
14 liability, as may be the case with Citizens, the Commission should order that the financial benefit
15 from the reduction of the liability be considered an enhancing return to the equity owners thus
16 reducing STRANDED costs. For example, if removing a burdensome liability does affect equity
17 values held by owners, such as stock prices, these enhanced values should be offset against the
18 loss on the sale of the asset.

19
20 IV.

21 IMMEDIATE, STATEWIDE OPEN ACCESS COMPETITION IS ESSENTIAL TO
22 AVOID OVERPAYMENT OF STRANDED COSTS
23

24 The great weight of the evidence in the stranded costs hearings is that opening new
25 markets sooner will make a huge difference to achieving the vision of competition that this
26 Commission must have according to Mr. Fessler, (Fessler, 2/10/98, tr. p. 548, l. 2-5); the vision
27 that Dr. Rosenberg described so clearly. (Rosenberg, 2/18/98, tr. 2225-2230.) This is because the
28 greater, (and the sooner) the opportunities for new sales become available to the Affected Utilities,

1 the greater the reduction of stranded costs. (See Breen, 2/9/98, tr. p. 80, l. 8-10, p. 105, l. 25-29, p.
2 106 l. 1-7, p. 110, l. 11-12.)

3 It does not take a Ph.D. in economics to determine that if a company can sell a substantial
4 volume of generated power in new markets, its revenues go up, its cost of production per unit goes
5 down, and its prices stay pegged to cost. If APS sells Palo Verde power at a retail (not a
6 wholesale) price to new customers in TEP's territory of Arizona by 2000, its stranded costs will
7 be lower. If APS's stranded costs are lower, the CTC paid by its ratepayers will be lower. If the
8 CTC is lower, there will be more room for competitors to offer residential consumers better rates
9 than they had under regulation. If new competitors come in and take some of APS's old
10 customers, then if APS sells at a retail price in Southern California APS's stranded costs still are
11 lower, the CTC charge in Arizona is lower, and so on.

12 The dramatic effect of new market opportunities is underscored by the remarkable absence
13 of any actual consideration of the value of these opportunities to offset stranded cost. APS wants
14 cost-less-wholesale price without reference to offsetting sales. Although Mr. Breen said that the
15 Commission should offset the plus-assets with the minus assets, (Breen direct testimony, 1/9/98, p.
16 14, l. 12-14, p. 17, l. 7), Citizens seems to want cash value of over-market APS contract sale,
17 structural financial benefit from freedom from its largest liability without offsetting the increased
18 revenues and other market penetrations the low-cost power will enable it to make.

19 TEP failed to mention that it expects revenues from its retail storefront in Phoenix and its
20 internal plans to market in SRP's territory in formulating its net loss revenue plan. TEP surely
21 plans to try to sell power in AEPCO's territory south of Tucson.

22 There must be an opening of opportunities to market to new territories coincident to the
23 commencement of competition. (Breen, 2/9/98, tr. p. 80, l. 8-10, p. 105, l. 25-29, p. 110, l. 11-21.)
24 CC&Ns simply must go, not in a separate rule making docket but here and now, as a fundamental
25 matter to be resolved before stranded costs are calculated. (Rosenberg, 2/18/98, tr. p. 2226, l. 24-
26 25, p. 2227, l. 1-4; Lopezlira, direct testimony, 1/21/98 p. 4, l. 5-24.) There is ample evidence in
27 this record that new market opportunities will go a long way to reduce stranded costs. This aspect
28 of the Attorney General's proposal, along with the essential implementation of non-discriminatory

1 open access rules (Rosenberg, 1/18/98, tr. p. 2226, l. 5-10; Lopezlira direct testimony, 1/21/98, p.
2 6, l. 24-28, p. 7, l. 1-9) are perhaps the most important ones, and were endorsed by many in this
3 proceeding. The Commission's order must provide for the elimination of the unwieldy CC&N
4 process and entitlement, provide a FERC-type open access rule, and open the entire state to
5 competition.

6
7
8 **V.**

9 **SHARING STRANDED COSTS BETWEEN SHAREHOLDERS AND RATEPAYERS**
10 **WOULD PROPERLY BALANCE RISKS AND MANAGEMENT INCENTIVES**
11

12 Shareholders invested in APS, TEP and Citizens at times of risk, as evidence by the
13 negative consequence that befell TEP's stock when management chose the wrong, costly path. All
14 shareholders assume a certain amount of risk. Mr. Meek admitted that the shareholders he
15 represents understood that, as to generation, the Commission ordered a certain capacity, but
16 management decided how to acquire it. It was management's choice to opt for long term
17 wholesale market based contracts, or to build nuclear power plants. The shareholders did not
18 know going in whether Palo Verde would be fully approved or whether any of TEP's coal-fired
19 plants would be fully reimbursed. In fact, millions in Palo Verde costs were disallowed by the
20 Corporation Commission. Yet the shareholders did not flee APS, they stayed. (Exh. A.G. 4.)

21 The Affected Utilities are saying that because they had to provide capacity, they are
22 entitled to full stranded cost recovery (in the vernacular of the Affected Utilities, stranded equals
23 "unreimbursed) even if its choice of facility to generate was management error, and even if the
24 shareholders assumed some of the risk. Management of the IOUs, like the shareholder group,
25 wants to "keep it coming" at the expense of ratepayers and to the detriment of competition.

1 VI.

2 ALL CUSTOMERS SHOULD PAY A METERS CHARGE BASED ON HISTORIC
3 USAGE TO FAIRLY SPREAD THE BURDEN OF STRANDED COSTS
4

5 A meters charge is simplest and does not raise barriers to entry. Although there seems to
6 be an inequity in the idea that a consumer who had an efficient utility may, if he moves, have to
7 pay for a utility that was inefficient, the fact is that in a competitive market that happens all the
8 time and no one is owed a duty to correct it. A person without a car may be relegated to a smaller,
9 less efficient and more costly grocery store than one who can travel wherever triple-coupon values
10 are offered.

11 The Attorney General provided the most detail in how to collect, bill for and distribute the
12 CTC. In Exhibit A.G. 3, the Attorney General described the initial billing statement, subsequent
13 billing statement, how the CTC would be disclosed, who would manage the fund from which the
14 stranded costs, (if any), would be distributed to utilities. Unlike Citizen's plan, the Attorney
15 General does not recommend a separate bureaucracy, but merely a form of separate checking
16 account.

17 There is no substantial evidence in this record that this simple method of allocating, billing
18 and collecting is not feasible. If the Commission wants to keep its 1999 deadline, adopting this
19 simple meters charge will do the job.
20

21 VII.

22 THE ATTORNEY GENERAL'S POST-HEARING ANSWERS TO THE COMMISSIONS
23 NINE QUESTIONS
24

25 1. Should the Electric Competition Rules be modified regarding stranded costs, and, if so,
26 how?

27 Yes. The Attorney General makes a number of recommendations for amendment. The
28 most important of which are to clarify that generation and retail services markets are the product

1 markets to be deregulated, and the elimination of CC&Ns and amendment of percentages to open
2 retail markets to competition statewide, with the CC&N procedure to be replaced by a licensing
3 procedure. See Lopezlira direct testimony, filed 1/21/98, p. 3-7.

4
5 2. When should Affected Utilities be required to make a stranded cost filing pursuant to
6 AAC R14-2-1607?

7 Within 30 days after the second stock evaluation has occurred, (APS), upon closing the
8 sale of divested assets, (TEP, AEPCO, Citizens and the Cooperatives); upon the completion of an
9 appraisal (if that market method is chosen).

10
11 3. What costs should be included as part of stranded costs and how should those costs be
12 calculated?

13 Any amount by which stock values (APS), generation asset sale proceeds (other Affected
14 Utilities), or appraisal values (if chosen) are below book value should be considered a stranded
15 cost. See Exh. A.G. 3, copy attached, regarding the stock valuation method.

16
17 4. Should there be a limitation over the time frame over which stranded costs should be
18 calculated?

19 The time frame is the before-and-after-rules- finality for the stock split (see Exh. A.G. 3),
20 the customary time frames for calculating book values at the time of sale or appraisal finality.

21
22 5. Should there be a limitation on the recovery time frame for stranded costs?

23 Yes. Five years. (See Exh. A.G. 3) Any market-based method can be handled in the same
24 way and within the same time frame as the stock market method set forth in Exhibit A. G. 3.

25
26 6. Who should pay for stranded costs and who, if anyone should be excluded from paying
27 for stranded costs?

28 Every user of power at the time competition begins, based on historical usage. The charge

1 should be a "meters" charge based on location of the meter, not the customer, although it may be
2 necessary to charge future customers to spread the burden. No one should be excluded.

3
4 7. Should there be a true-up mechanism and, if so, how would it operate?

5 No. None will be needed with the market approach.

6
7 8. Should there be price caps or a rate freeze as part of the development of a stranded cost
8 recovery program and, if so, how would it be calculated?

9 No. Rate caps and freezes distort the markets and create artificial parameters around retail
10 prices. Rate caps and freezes can drive prices higher and become barriers to entry.

11
12 9. What factors should be considered for "mitigation" of stranded costs?

13 Offsetting benefits such as gains in shareholder stock value; gains in value of generation
14 assets realized on sale; equity gains from elimination of burdensome power contracts. Gains from
15 potential sales of power in new retail markets will naturally be considered by market buyers and
16 investors. If a market approach is not used, such gains should be offset against stranded costs
17 calculated in any other way.

18
19 **VIII.**
20 **CONCLUSION**

21
22 This proceeding has proved one fact conclusively - there are available a number of fast and
23 efficient market-based methods of valuing stranded costs that will correctly balance the equally-
24 important interests of utilities' investors in recovering their stranded costs, of ratepayers in not
25 overcompensating investors, and of the Commission, in moving toward competition. The market-
26 based methods proposed here fulfill the regulatory promises made, if any, protect consumers from
27 overpayment, do not artificially distort the future market, do not reward inefficiency, do not create
28 barriers to competitive market entry or protect monopolies. Article 14, § 15 of the Arizona

1 Constitution says that monopolies shall not be permitted in this state. Although regulated
2 monopolies are lawful, the preservation of monopolies in a competitive environment is not.

3 The good and timely decision to move to competition has been made. Now, the
4 Commission to complete the process. The record in these proceedings requires this Commission
5 to employ that market-based method of awarding stranded costs most likely to minimize the costs
6 and, therefore, the burden on the future. The citizens of Arizona have the right to expect no less.

7
8
9 RESPECTFULLY SUBMITTED this 16th day of March, 1998.

10
11 GRANT WOODS
12 Attorney General

13
14 By: _____

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20
21
22
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27
28

STOCK MARKET VALUATION PLAN

STAGE 1:

BOOK VALUE	12/31/98	\$5b
ADJ. STOCK VALUE	3/1/99 - 3/3/99	4b

STRANDED COSTS: \$1b

B STOCK COUPON
\$1b

STAGE 2:

STRANDED COST RECOVERY FUND EST.
(ACC FUND) TO COLLECT:

\$200MM/year (for 5 years)

STAGE 3:

SPECIAL BILLING

Generated by Affected Utilities

Customer Name	1996 Useage	Annual/Monthly Stranded
John Doe	10,200 kWh/yr 850 kWh/mo	\$72.24/year 6.03/mo

STAGE 4:

CUSTOMERS CHOOSE - SUPPLIERS BILL/ REMIT ST. COST \$ TO FUND

<u>Company/ Customer</u>	<u>Current Useage</u>	<u>Future Useage</u>	<u>Useage Bill Amount</u>	<u>Stranded Cost Charge</u>	<u>Bill Total</u>
A. John Doe	850 kWh	850 kWh	\$100.00	\$6.02	\$106.02
B. Jane Doe	850 kWh	1000 kWh	95.00	6.02	101.02
C. Jack Doe	850 kWh	1200 kWh	92.00	6.02	98.02

TOTAL ANNUAL COLLECTED

\$200MM (paid to S.C.R.F.)

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